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The GRAT's Last Gasp, Unbundling Reprieved, and the Eyjafjallajökull of the Estate Tax

By Robert L. Moshman, Esq.

Ironic twists that impact estate planning were contemplated as an initial organizing principle for this collection of recent developments.

However, the rich veins of irony that run through the subject matter of taxation are so bountiful that merely scratching at the surface soon yields gushers of irony. Cases redolent in irony. Issues saturated in irony. A legislature that is never shamed by the tsunami of irony it produces.

Oh, the irony!

We have therefore limited these selections to just a few areas. The same Congress which forgot to stop the estate tax from being repealed entirely (oops) and which has failed to reimpose it at 2009 rates retroactively for four months and counting (whoops) has ironically set in motion a stringent limitation on a popular wealth transfer technique, the Grantor Retained Annuity Trust (GRAT).

Presented With Our Compliments

ONot to be outdone, the IRS, which has tried to unbundle investment fees but hasn't come up with a viable means of doing so, has now, ironically enough, postponed its own edict for the third successive year.

And Eyjafjallajökull isn't just a catchy name for a volcano. It is a metaphor, an analogy, and a device to report on the latest estate tax un-repeal developments. There is sure to be an ironic element in that mix upon closer inspection.

The GRAT Killer

Time may be running out on one of the best wealth transfer strategies of the past generation. It's a tad ironic that during a period of time when the Federal estate tax remains repealed—and Congress remains immobilized and irresponsible in addressing this on the record—that Congress has found the time to slip a provision curtailing wealth transfers into a jobs bill.

Yep, they did exactly that. In March, the House of Representatives approved H.R. 4849, the Small Business and Infrastructure Jobs Tax Act of 2010. Obviously, no one is mistaking a grantor retained annuity trust for anything related to jobs or infrastructure, yet hitching a ride on the bill is a GRAT killer provision that imposes a minimum term of 10 years on GRATs.

Even more remarkably (and doubling the ironic content of this maneuver), the motivation behind the GRAT change is to balance out other job-related measures with a \$4.5 billion revenue-raising measure that addresses persons taking advantage of gift tax savings.

But GRATs are in use currently because a) everyone accepts the fact that Congress will get around to reinstating the estate tax so lifetime transfers make sense if they avoid gift tax by using GRATs, and b) the current attractive GRAT options exist. Once those methods are closed off to genuine savings, that river of assets will no longer flow into the same gift tax revenue servitude via GRATs. Rather, those assets will flow into other more effective wealth transfer devices or be held until death. And then the reinstatement of an estate tax that follows (and which will undoubtedly be linked with a return to the stepped-up basis) will encourage more grantors to hold appreciated properties until death and not enter such assets into job-producing endeavors in the present economy.

In all likelihood, the imagined revenue-raising components of the bill are a fiction. But the net impact on GRATs is a reality. This will bring an end to a great device, and many planners are advising clients to grab the last GRATs. For some perspective, here is a synopsis of background on GRATs that we

provided in the 2006 *Estate Analyst* article, "Good GRATs and Great GRATs."

A Recent History of GRATs

In the 1980s, a new generation of lawyers had refined the trust concept to the point where estate values could be effectively frozen by splitting beneficial trust interests between a grantor and a beneficiary. Then Congress laid down the law! Specifically, it restricted dishonorable valuations of split-interest trusts by adding Chapter 14 to the Tax Code in the Omnibus Budget Reconciliation Act of 1990.

A Safe Harbor: Despite cracking down on estate-freezing techniques, Chapter 14 provided a beautiful safe harbor. The grantor retained annuity trust, better known as GRAT, is explicitly authorized under Section 2702.

Once assets are placed in a GRAT, the respective interests of the grantor and the future beneficiary can be carefully measured using Treasury tables and then taxed accordingly. The more valuable the grantor's retained interest, the lower the value of the transferred interest.

The grantor of a GRAT receives annuity payments for a fixed term. Thus, if the assets placed in a GRAT grow faster than the rate assumed under Section 7520 (the Treasury's valuation tables), the extra growth ends up belonging to the remainderman.

Treasury regulations arrived in 1992. This apparently gave practitioners the comfort level to explore the limits of this safe harbor. By late 1993, the lawyers had gained the upper hand yet again.

By creating a GRAT with a short term of two or three years and a maximum rate of return, the valuation of the remainder can be reduced almost to zero.

The GRAT was thought to be the golden chalice of estate tax planning, i.e., a way to reduce transfer taxation to zero. Authors called the new approach "SuperFreeze" at the time, but the term SuperGRAT is the name that has stuck.

Zeroing In, Zeroing Out: Sometimes great art is not immediately recognizable. In 1913, the Parisian audience booted with contempt for Stravinsky's "Rite of Spring." The artistic community shunned Vincent van Gogh during his lifetime.

Similarly, SuperGRATs were not fully utilized for many years. The root of the problem was Reg. §25.2702-3(e), example 5, under which a grantor could retain no more than a "qualified interest" in a GRAT. This allowed for the potential that the grantor could die before the term of the annuity.

In a unanimous (13-0) *en banc* decision, the Tax Court rejected this interpretive dance step. Thus, on December 22, 2000, *Walton v. Commissioner* paved the way for lots of SuperGRATs.

But over the following six months, the estate tax repeal became serious. On June 7, 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act. And the years that followed were at the peak of the FLP frenzy that gripped the estate-planning community.

All the while, the zeroed-out SuperGRAT from the early 1990s has remained eminently effective, sublimely simple, and comfortably anchored in its safe harbor.

Until now.

Currently, the minimum term for a GRAT is two years. A minimum term of 10 years, as appears to be imminent, drastically increases the mortality risk. If the grantor dies within the 10-year term, the trust assets end up being included in the grantor's estate for tax purposes. The proposed law would also block "zeroed out" GRATs that are structured with a zero remainder interest (so that assets can be transferred without gift tax consequences).

It is anticipated that the new GRAT restrictions will save \$4.5 billion over the next decade. Or putting it another way, taxpayers will not be able to avoid \$4.5 billion in taxes using GRATs...they will have to find alternative planning techniques. The Senate is expected to approve these measures (and may have by the time this is circulated).

The April 4, 2010, *InvestmentNews* report on this ran under the headline "Wealthy may have to kiss their GRATs goodbye." Some advisors are urging clients to set up GRATs before it is too late.

A Bundle of Joy

The IRS recently provided Notice 2010-32, published in the Internal Revenue Bulletin of April 1, 2010, which has given fiduciaries of estates and trusts another reprieve from having to "unbundle" investment fees for the purpose of determining which portions of fees are fully deductible and which are subject to the 2% floor. The reprieve applies to tax years commencing prior to January 1, 2010.

At first blush, this might appear to be a rare moment of latitude and benefaction, a gesture of goodwill and charity from the Internal Revenue Service, which has empathy toward the beleaguered fiduciaries of the nation and their accountants.

On closer inspection, however, this is not an invitation to have a drink on the house and go dancing with happy old Marley, but it's a crusty old token from Scrooge. First, note the timing. It was delivered, essentially, for the 2009 tax year about two weeks before returns for 2009 were due.

In the real world, most of those returns are filed on extension; for trusts, that now means a September 15, 2010, deadline. (Note: The change in this deadline took place last year and may have caught many fiduciaries and accountants by surprise.)

So an accountant or fiduciary who was ahead of the game had already unbundled the trust's investment fees and filed accordingly and will have to weigh the value of filing an amended return.

A taxpayer who filed an extension and had five months left to figure out the unbundling of the various fees for the various portfolios now can turn to the 2010 tax year, already underway, and contemplate the various fees that arrive in multiple accounts and portfolios—without any coherent explanation of which services are included, how they are priced, or whether they meet the Supreme Court's criteria for being exempted from the 2% floor rule.

Stay Bundled: The latest reprieve from the IRS is a self-serving admission that they don't yet have a workable articulation of the Supreme Court's approach to apply to Code Section 67.

This is the third such reprieve since the Supreme Court handed down *Knight*. The initial reprieve arrived in *Notice 2008-32* and applied to tax years commencing prior to January 1, 2008. This came in the wake of hearings at which professionals from banking, law, and accounting associations testified about the expense of unbundling investment services to determine which components would be deductible. *Notice 2009-116* then extended the reprieve though January 1, 2009. The most recent *Notice 2010-32* is the third reprieve from unbundling, indicating the difficulty in providing a workable approach.

This has been an area of contention since the arrival of the 2% floor in 1987 but has received great attention over the past two years as a result of the Supreme Court's decision in *Knight v. Commissioner*.

Under IRS Section 67(a), a taxpayer's miscellaneous itemized deductions must exceed 2% of the taxpayer's adjusted gross income. Under IRC Section 67(e), the same rule applies to trusts and estates, except that expenses which would not

have been incurred but for being in an estate or trust are not subject to the 2% floor.

Proposed Unbundling: In 2007, the Treasury proposed a specific test, i.e., whether the expenses are “unique” to trusts or estates. The Second Circuit Court of Appeals, in an opinion written by then Judge Sotomayor, applied this test.

In *Knight v. Commissioner*, 128 S. Ct. 782, 552 US 181 (2008), the Supreme Court backed away from the uniqueness standard, sidestepped the “unbundling” concept, and concluded that fees and expenses not “commonly incurred” by individuals are deductible without being subject to the 2% floor.

But trusts and estates are not invested in the same way as individual accounts or retirement accounts. And services aren’t broken down by providers into convenient categories of “fully deductible” and “deductible above 2% of AGI.”

Nor can fiduciaries determine “commonly incurred” expenses without unbundling fees, so they are no better off with that standard than with the previous “uniqueness” standard. And, apparently, the IRS hasn’t figured out how to effectively monitor the allocation of bundled services either. In fact, no one has. It involves conducting an autopsy on fees and services that are old and cold and which require auditors, bankers, investment advisors, and accountants to perform more work and services than the original services required. The whole unbundling concept was ill-conceived.

The IRS may need years of psychotherapy to open up and admit this. In the meantime, we can expect an annual IRS Notice with a reprieve from unbundling.

Estate Tax Eyjafjallajökull

The volcanic eruptions of Eyjafjallajökull (meaning “island mountain glacier”) in Iceland were responsible for a dust cloud that a) grounded a lot of planes in Europe and b) made a lot of people revise their opinions of Iceland from being a large block of ice in the ocean where not much goes on to being an international nuisance.

If you can avoid swallowing your own tongue while trying to pronounce it, compare Eyjafjallajökull to the repeal of the Federal estate tax. It smolders along for about a century before doing something significant in 2010. It casts a giant, dark cloud over everything and throws large portions of economic activity into limbo. No one is certain what it will do next or when that will occur.

In the case of the estate tax, it is conceivable that a member of Congress could propose a revision of the tax, die while the idea is discussed, have his estate remain open for longer than the normal filing deadline for estate tax returns, and then have Congress vote on his idea (posthumously) and impose a retroactive tax. Although Congress may act very soon on the retroactive imposition of the tax, we are getting closer to some of these amazing issues. Someone who died on January 1, 2010, would need to have Form 706 filed within nine months from the date of death (in this example, September 1, 2010) or have Form 4768 filed to obtain an automatic six-month extension. But because the estate tax has been repealed, there has been no reason to file any return or seek an extension—unless there is a retroactive estate tax.

Democrats appear to be favoring the \$3.5 million exemption from the estate tax that existed in 2009. Republicans may be angling toward a \$5 million exemption. An educated guess would predict the \$3.5 million exemption being indexed for inflation.

Last December, the House voted to make the 2009 rates permanent. During February budget discussions, it appeared that Congress was prepared to adopt a two-year extension of various Bush-era tax cuts and, along with that, a two-year continuation of 2009 estate tax rules and rates.

Last year, Senator Max Baucus supported a bill that provided for the reunification of estate and gift taxes with a \$3.5 million exemption for gift taxation. Presumably, the return to an estate tax will also mean the return to a stepped-up basis for long-term capital gains on appreciated assets held at death. And there has been some mention of a state death tax credit. It appears the old gang is getting back together for a reunion like an ’80s band!

When will the estate tax be restored? An excellent estate planning Website, *KYEstates.com*, is running a contest to see who can predict when the estate tax will return. The Steve Leimberg estate planning newsletter served up an effective April Fools Day offering that said Congress had taken action...before revealing the joke. [Editor’s Note: This editor bought it hook, line, and sinker.]

But with the inclusion of the gift tax-related GRAT measures in the House version of the Jobs bill, there is a push in the Senate to provide an estate tax measure in return for pushing the jobs bill through. Stay tuned.